would look fundamentally different in future years is not realistic nor is it sound as a basis for regulatory policy. [IAWC Ex. 9.0SR, p. 17.]

Mr. Smith's concerns with the ability to incorporate differing variables over the duration of the SSP period (ICC Staff Ex. 7.0, p.5) are unfounded. It is not necessary to speculate, today, at the infinite number of possible internal changes Citizens might go through over the 40-year period. Future changes in the operating environment will be addressed as they arise at the proposed rate case reviews, and for a water utility, are not likely to be significant, given the nature of ongoing cost activity, i.e. heavily service oriented. Further, the majority of the Savings arise because of duplication and economies of scale, not gains in productivity which could be achieved absent the Acquisition. In any event, the SSP has incorporated opportunities to review such changes in the rate case evaluation process. [IAWC Ex. 9.0SR, pp. 17-18.]

The Staff witnesses' concerns regarding the quantification of Savings in periods subsequent to the savings event are also unfounded. As Mr. Flaherty indicated, the Savings resulting from a savings event are readily discernible in future years. Once a savings event occurs, it can be periodically reviewed (in rate proceedings) to determine the change or effect, if any, of any exogenous factors. Commissions frequently deal with events of a long term nature. [IAWC Ex. 9.0SR, p.18.]

Under the SSP, Savings will be identified as specific events which can then be quantified, verified and reviewed periodically. Further, comparisons can be made to an agreed upon baseline cost structure prior to the transaction, which can also be verified. As the plan progresses into future periods, these savings events can be reviewed, as they occur in any period, and previous events revisited to ensure that they are still valid and generating verifiable Savings for the ratepayers. Detailed records related to changes in cost levels and the effect, if any, of exogenous factors on cost savings will be maintained. [IAWC Ex. 9.0SR, pp. 18-19.]

Use of savings sharing plans and forecasts are not anomalous in the ratemaking environment. Many regulatory bodies have approved and operate under them without undue effort. One example of such a plan is contained in the Rhode Island decision regarding the New England Electric System (NEES)- EUA acquisition, *Narragansett Electric Company*, Docket No. 2930, Order No. 16200, 2000 WL 779757 (R.I.P.U.C., March 24, 2000), 201 PUR 4th 106, which provided for adoption of a twenty-year savings sharing proposal, development of a long-term forecast, subsequent verification of the "enduring nature" of the savings and actual forecast comparison of savings and costs. The SSP contains many of the same safeguards as are included in the NEES-EUA plan that allows for the verification and quantification of cost savings. The use of event-based savings tracking ensures the ability to identify, quantify and document Savings in future periods and provides verifiable evidence of cost reduction. These events, as documented, will contain all the elements necessary to create Mr. Smith's desired "audit trail". For instance, in the case of the terminated employee position, documents will exist evidencing the reason for termination, the cost of the employee, and the function of the employee; all of which are verifiable. With respect to cost levels absent the Acquisition, the baseline, future cost and escalation calculations will be available for verification and review at each of the future ratemaking hearings.[3] Any company-generated assumptions can be tested for reasonableness by

[3] For example, if the role of human resources manager is eliminated and replaced with an allocated cost per employee from a corporate affiliate, the net difference between the allocation and the cost of a human resources manager becomes a savings. To the extent a human resources manager is not subsequently hired, and the corporate parent continues to perform that function, then the total Savings remains valid. The Savings would, however, change as the salary of a human resources manager relative to the allocated cost changes over time. [IAWC Ex. 9.0SR, p. 20.]

the Commission through a paper trail beginning with the first savings event. [IAWC Ex. 9.0SR, pp. 19-20.]

Under the SSP, an allocation of savings to shareholders is made only in the event that the Company is able to demonstrate at the time of a rate case that Savings solely attributable to the Acquisition are reflected in the particular rate case test year. If the Company maintains, at the time of a rate case, that Savings are attributable to the elimination of employees, it would be necessary for the Company to demonstrate, at the time, that the elimination resulted directly from the Acquisition. If the Commission concludes that the elimination of employees resulted from other factors, such as technological advances, the resulting savings would not be a basis for an allocation of Acquisition Savings to the shareholders. As noted above, the burden to make the necessary demonstration rests with the Company. [IAWC Ex. 1.0R, pp. 7-8.] Furthermore, it is only logical that staffing reductions will occur at a significant level to eliminate duplication in certain headquarters and back-office functions. [IAWC Ex. 9.0R, pp. 10-11.] IAWC projects that 25 positions will be eliminated and has submitted data underlying this projection in detailed work papers. While Staff and IIWC speculate that this projection may not be accurate, they offer no basis for their speculation. [*Id.*, p. 11.] For example, Mr. Gorman [IIWC Ex 1.0, p. 12] questions whether the reduction of 25 employee positions could be achieved absent the acquisition. Exhibit 3.2 indicates that the 25 positions represent a reduction of 30 positions and the addition of 5 positions that have been identified to directly result from the Acquisition. Savings identified by the Company and reflected in the SSP are based upon an in-depth analysis and review of CUCI and IAWC operations on a stand alone basis and identification of Savings that will result from consolidating the two companies into one.[4] To the extent the Company is

[4] As one example, a position identified for elimination is "Manager-Procurement". In evaluating personnel requirements for the consolidated operation, there were no requirements for additional management personnel in

unable to meet its burden of proof that any portion of such Savings are not a result of the consolidation, the related Savings will not be subject to recovery through the SSP. [IAWC Ex. 3.0R, p. 3.]

f. Specific Savings Items

Mr. Gorman questions whether the 12% corporate overhead charge on construction projects could be eliminated without the Acquisition. [IIWC Ex 1.0, p. 12]. As Mr. Stafford explained, this charge represents services, in the form of charges from the Stamford Administrative Office and the Public Services Organization, provided to CUCI, and is in addition to local supervision and review added to the cost of construction projects. These additional services would not be necessary in the combined company and, therefore, would not be billed on IAWC projects. Only labor and related charges from IAWC personnel (or contractor charges if the work is contracted out) are included on similar projects under IAWC management, unless personnel from the Service Company are directly involved in the engineering and supervision of a project. [*Id.*, pp. 4-5.] Once again, the SSP requires a demonstration of the actual level of Savings reflected in the test year data in future rate cases. There would be no allocation of Savings to shareholders based upon the Company's current estimates. Any such allocation will be based on a demonstration of actual Savings, in future rate cases. Accordingly, Mr. Gorman's criticism of the estimates provides no basis to reject the SSP. [*Id.*, p. 5.]

Mr. Gorman also suggests that savings attributable to lowering CUCI's common equity ratio and reducing its overall cost of capital should not be attributed to the proposed Acquisition.

(continued...)

the area of procurement. Existing IAWC personnel can perform the management and supervisory responsibilities for this function in the consolidated organization. The elimination of this position represents labor savings directly resulting from combining the two operations into one. [IAWC Ex. 3.0R., pp. 3-4.]

Mr. Gorman agues that CUCI could restructure its capitalization and reduce its common equity ratio to 45% absent the Acquisition. However, this argument is without factual basis. As Mr. Stafford explained, the Illinois Commerce Commission has reviewed the appropriate mix of debt and equity capital in establishing rates for CUCI on a stand alone basis. In establishing rates for CUCI in Docket No. 84-0237, the Commission used a 65% common equity ratio, and in Docket No. 87-0493 it found that the appropriate common equity ratio was 60%. Similarly, the common equity ratio used to set rates in CUCI's most recent rate case, Docket No. 94-0481, was 59.37%. Thus, during at least the last 15 years, the common equity ratio used to set rates for CUCI has been at least 59.37%. As Mr. Gorman recognizes at page 13 of his testimony, IAWC's proposed capital structure of 45% common equity (compared to CUCI's historical 60% common equity) will reduce customer charges through lowering of the overall cost of capital used to set rates. [IAWC Ex. 3.0R, pp. 5-6.] In any event, as in the case of other Acquisition Savings, the Commission need not determine in this case whether a reduced cost of capital is a proper element of Acquisition Savings or not.

g. The Savings Measurement Process

Mr. Borden suggests that the SSP is an arbitrary allocation between ratepayers and shareholders of future Savings supposedly generated by the Acquisition. [ICC Staff Ex. 5.0, p. 4.] The measurement of Acquisition Savings under the SSP, however, is not an "arbitrary" amount, as it must undergo the scrutiny of either a rate case or review of a savings report, as discussed by Mr. Ruckman. Moreover, the SSP provides an incentive for IAWC to continue to generate savings over the long term (at least 40 years). [IAWC Ex. 8.0R, p. 12.] As Mr. Mülle explained, the result of the SSP is to allocate reasonable portions of the available net savings to the shareholders (to compensate them for acceptance of the economic risk reflected in the Acquisition) and to customers. In unregulated circles, customers would not share in acquisition savings. The entire savings would be allocated to the shareholders, as their reward for increasing management efficiencies. In other words, for an unregulated entity, all savings, not just some, are available to pay for the transaction premium and provide a return to the acquiring company. The investor in a competitive entity would not knowingly agree to subsidize an acquisition with no potential return to the investor. [*Id.*]

Ms. Everson points out that the factors used in the Company's projection of Savings over a forty (40) year period can vary over time, thus altering the timing and amount of savings. [ICC Staff Ex. 2.0, pp. 5-6.] Ms. Everson is certainly correct in suggesting that the timing and amount of savings may vary over the forty (40) year amortization period. However, any difficulty in projecting conditions over a forty (40) year period is not a basis to reject the SSP, as the risk of proving the existence of such Savings rests wholly with the shareholders. [IAWC Ex. 3.0R, p. 2.] Ms. Everson acknowledged that she had done no study or analysis to support her position that the determination of Savings levels in rate cases over the 40-year period of the SSP would be difficult. [Tr. 715.]

Mr. Flaherty addressed both Staff's and IIWC's criticism that there is no suitable measurement process available for utilization in implementing the SSP. [IAWC Ex. 9.0R, p. 17.] Mr. Flaherty explained that Staff and IIWC are simply commenting on the degree of complexity associated with implementation. This is not an insurmountable or unique problem. It should certainly not be used as a reason to deny the ratepayers the benefits that will be produced by the Acquisition or the shareholders the compensation to which they are entitled for making the investment necessary to create these benefits. [*Id.*, pp. 18, 20.]

Mr. Flaherty explained that the elements of the SSP are not particularly unique. As Mr. Flaherty indicated, most recent reorganization transactions approved by regulatory commissions have included some form of merger or acquisition cost savings sharing method. These methods commonly seek to achieve an equitable distribution of savings between customers and shareholders, dependent upon the circumstances of each specific transaction. The SSP incorporates several components that are common to most regulatory plans, *i.e.*, a specific approach to sharing, quantified proportioning of savings, a defined time frame, discrete mechanisms related to the operations of the plan and a basis for proving up actual savings. These components thus provide the necessary elements of a workable savings sharing proposal. [IAWC Ex. 9.0R, pp. 20-21.]

As Mr. Flaherty further explained, the SSP is composed of distinct components; Acquisition Revenue Requirement, Acquisition Savings, and allocation, all of which are required to be defined pursuant to Section 7-204(c) in this proceeding. Administration of the plan in future periods will occur under the authority of the Commission in future rate proceedings. The Acquisition Savings will be quantified in the rate case process by evaluating actual savings resulting from the Acquisition. Upon quantification of actual Acquisition savings in future rate case proceedings, the allocation of Savings between customers and shareholders will automatically follow under the SSP approved in this proceeding. There will be no need to discuss or contest the Acquisition Premium Revenue Requirement or allocation, in future proceedings, as they will be determined here, which further simplifies the process. [*Id.*, p. 26.]

As noted above, many commissions have approved savings sharing proposals and savings demonstration approaches. In *Public Service Company of New Hampshire, et. al.*, Docket DE 00-009, 2000 WL 1930708 (N.H.P.U.C., Dec. 6, 2000), 205 PUR 4th 307, for example, the New Hampshire Public Service Commission ("NHPSC") approved a merger savings sharing proposal under which the percentages of estimated merger savings allocated to ratepayers and shareholders were 75% and 25%, respectively. Under the plan, ratepayers also would receive any excess of actual savings over the estimated amount. To demonstrate the level of actual savings, the NHPSC approved a stipulated "Demonstration Mechanism." 2000 WL 1930708, at *19. As stated by the NHPSC:

> Under this so-called demonstration mechanism, savings "would be primarily demonstrated by setting 1999 Corporate Center Charges related to PSNH transmission and distribution as the baseline," with these charges adjusted to reflect actual wage increases since 1999, changes in services or functions, productivity gains and other items, yet to be determined, that are deemed unrelated to the merger. Test-year corporate center charges would be subtracted from the 1999 corporate center charges, as adjusted, with the results divided by 60 percent to reflect that an estimated 60 percent of merger savings are related to corporate center functions. PSNH would be required to present supporting documentation for the savings attributable to corporate center charges. The Settling Parties agreed that if the result of this calculation is greater than the estimated net savings set forth in Attachment A, PSNH would be deemed to have adequately demonstrated its entitlement to its share of the savings, but if the results were less than the level of savings specified in Attachment A then the gross-up to PSNH's adjusted revenue requirement would be limited on a pro rata basis to the results of the demonstration. Attachment B further provides that, "at the time of any future rate proceedings, intervenors retain the right to argue in favor of or against the ability of these indicators to actually demonstrate savings."

Order, p. 10-11.

A long-term savings sharing program also was approved by the Rhode Island Public Utility Commission ("RIPUC") in *Narragansett Electric Company*, Docket No. 2930, Order No. 16200, 2000 WL 779757 (R.I.P.U.C., March 24, 2000), 201 PUR 4th 106. In that case, the RIPUC approved a settlement in a merger proceeding under which rates would be frozen for four years. After that date, the merged utility would be permitted to retain 50% of merger savings (2000 WL 779757, at *9, *19-20) through the year 2019. The RIPUC described the process for measurement of savings as follows:

> Achievement of savings shall be measured by subtracting the distribution measurement year COS revenue requirement described in (1) above from the adjusted Benchmark COS. For the purpose of this section, the adjusted Benchmark COS shall mean, the "Benchmark COS" ($210,000,000, which amount does not incorporate the effect of any merger related savings) escalated by 50% of the change in the "GDPIPD" from 2000 through the measurement year, plus the escalated Benchmark COS times 30% of the growth in the weather normalized measurement year KWH sales from the year 2000 KWH sales. For the purpose of this calculation, the year 2000 KWH sales are 7,098,202,000 KWH.

2000 WL 779757, at *19. The Order also provides that the measurement year cost of service should be adjusted up or down based on the occurrence of any "exogenous events." *Id.*

As Mr. Stafford explained, under the SSP, it is IAWC's burden to, within five (5) years from the date of the Order issued in this proceeding, come before the Commission with the specifics of a methodology that will allow the Commission to reasonably determine whether Savings have occurred and whether they are attributable to the Acquisition. If the Company fails in its burden of proof, it is the shareholders who are at risk and the Company will fail to recover the Acquisition Revenue Requirement. [IAWC Ex. 3.0R, p. 7.] In future rate cases, IAWC will present evidence that supports each identified Acquisition Savings component. Within this presentation will be information supporting the direct association of the Savings component to the Acquisition and a mechanism for measurement of such Savings, including support for the existence of such Savings over the long term. One way to compare costs on a stand-alone basis to costs for the combined entity would be to utilize known cost data related to a savings event for a particular year prior to the effects of the announcement of the Acquisition (e.g. year-end 1998) and trend the data forward to the time the Company files for recognition of Savings, utilizing known inflation or other appropriate factors. These costs can then be compared to test year costs for the combined entity. This would establish a baseline identification and quantification of achieved savings. [*Id.*, pp. 7-8.]

Mr. Stafford further explained that credible identification and quantification of Savings in the future is possible. It is appropriate, however, that the exact methodology for determining achieved Savings await consolidation of the entities and filing of a rate proceeding, when integration of the companies is well along or completed, and available data is better known. The point is that such methods do exist; they are routinely used; and their specifics will depend on the facts of the situation. [*Id.*, p. 8.]

Mr. Stafford discussed specific examples of how actual Acquisition Savings could be quantified. In the recent merger of Illinois-American with Northern Illinois Water Corporation, for example, a "Billing Clerk" position was eliminated based on the determination that the position was not required, as a direct result of the merger. The 1999 salary for this position was $24,672. The base line level of labor savings for this position is, therefore, $24,672. Actual salary increases for personnel in similar positions provides for a reasonable method of measuring savings for 2000 and beyond. In 2000, the average salary increase for personnel in similar positions is 3.5%. Therefore, the actual merger-related Savings in 2000 for this position are $24,672 increased by 3.5% or $25,536. Similar calculations could be performed for other labor and labor-related Savings to quantify actual Savings resulting from the consolidation. [*Id.*, pp. 8-9.]

Mr. Flaherty also addressed Messrs. Gorman's and Borden's concerns regarding measuring costs for the stand-alone companies. As Mr. Flaherty indicated, IAWC can effectively provide documentation to the Commission that captures each savings "event" and provides the necessary data to support its occurrence, Acquisition-relatedness and quantification. The Savings estimate provided by Mr. Stafford (IAWC Ex. 3.1R) is a useful prototype for capturing savings "events" because it identifies specific actions of management and economies of scale which will be implemented as a result of the transaction. [IAWC Ex. 9.0R, p. 28.]

For example, for staffing reductions, relevant information can be captured under simple templates that would specify the following types of data:

- Position
- Function
- Rationale
- Timing
- Salary
- Loading rates
- Activity disposition
- Variable/indirect costs

This data would enable the Commission to fully understand the Savings type and to determine whether the "event" was Acquisition related. More importantly, it enables the Commission to request and to review this data only once, since, absent exogenous factors, the Savings will continue into perpetuity. [*Id.*, pp. 28-29.] As Mr. Flaherty explained, an approach like this has been used before. The Utah Public Service Commission utilized such an approach in connection with the Pacific Power & Light - Utah Power & Light merger. *Utah Power and Light Co.*, 97 PUR 4th 79 (Utah SCC, Sept. 29, 1998). [IAWC Ex. 9.0R, p. 29.]

Savings in third-party costs, such as insurance or materials purchases can also be captured. In these cases, the measurements are based on unit costs which can easily be compared before and after the transaction to account for the effects of economies of scale. Those Savings that are variable or indirect, such as vehicles that may not be needed, or facilities that may be surplus, can be identified directly and related costs captured as well. [*Id.*, pp. 29-30.] Capturing direct data related to savings events provides an ability to establish a Savings level, which can be escalated each measurement period, as appropriate.

Mr. Flaherty also stated that, if the Commission would like to measure costs at a particular point in time, rather than simply capture the savings "event" and related Savings, that too can be accomplished. [*Id.*, pp. 14-17.] In two prior utility mergers, Kansas Power & Light - Kansas Gas and Electric and Entergy - Gulf States Utilities, the respective regulatory agencies utilized an approach referred to as the O&M index to reflect such future measurement. *Kansas Power and Light Co.*, 127 PUR 4th 201 (Kan. PSC, Nov. 15, 1991); Entergy, 146 PUR 4th 292. This O&M index, in fact, stayed in place for a number of years to facilitate the measurement process. [IAWC Ex. 9.0R, p. 31.] Generally, the O&M index fixes a baseline for future comparison of actual cost levels to expected cost levels. The actual cost levels are those that exist at the time of measurement, which would be an appropriate period prior to the transaction, unadjusted. The baseline cost level is determined by fixing a future cost level based on current cost levels, subtraction of expected cost savings, and escalating by an agreed upon or Commission determined factor. This baseline would also potentially allow for recognition of related costs, such as the acquisition premium. Under this methodology, the difference between the baseline cost level and future actual costs is presumed to be the Savings impact from the acquisition, as quantified by the company. [*Id.*, p. 32.]

To the extent that actual costs are higher than the baseline, as escalated, then it would be clear that Savings were not realized or that new costs have been incurred that were not in the baseline. To the extent that actual costs are lower than the baseline level, as escalated, these Savings were realized at a greater level than initially expected. Thus, if preferred, there is a way to measure Acquisition Cost impacts without measuring data for each "event". [*Id.*, p. 32.]

As Mr. Flaherty explained, the SSP can reasonably be implemented. No factors exist that are so unique that they cannot be addressed. The goal is equitable Savings sharing and methodology issues should not outweigh the benefits to be obtained by customers. These issues can be resolved without creating burdensome administrative processes or complicating results measurement, while assuring that customers do receive the intended Savings and other benefits of the transaction. [IAWC Ex. 9.0R, pp. 33-34.]

h. Allocation of Savings Among Rate Areas

Mr. Gorman states that he does not see how IAWC will be able to properly allocate Savings among service or rate areas. [IIWC Ex. 1.0, p. 15.] As Mr. Ruckman indicated, it is the Acquisition Revenue Requirement, not Savings, which will be allocated. [IAWC Ex. 2.0, p. 10.] Specifically, as discussed above, the Acquisition Savings will be allocated among rate areas based upon the level of Savings actually reflected in the rate case test year data for each area. [*Id.*] Savings would be "allocated" only to the extent that the reduced cost involved is common to more than one area. As Mr. Stafford explained, IAWC will be required to present evidence that chemical and other Savings are a direct result of the Acquisition. Such a demonstration would entail substantive evidence, for example, that the per unit price for chemicals is lower due to mass purchasing economies or, some other factor shown to have been a direct result of the Acquisition. The identification of Savings also requires identification of such costs absent the Acquisition. If such costs absent the Acquisition would have been directly assignable to one service or rate area, the resulting Savings will also be directly assigned to that service or rate area. Similarly, if such costs, absent the Acquisition, would have been assignable to more than one service or rate area, the resulting Savings will also be allocated to the common service or rate areas in a manner consistent with the allocation of such costs, absent the Acquisition. [IAWC Ex. 3.0R, pp. 6-7.]

Mr. Gorman further suggests that IAWC should be specific as to the amount by which each company is expected to benefit from reduced savings. As shown in the Company's response to Data Request IIWC-2, the majority of Demonstrated Savings (95.5%) are expected to be in the existing CUCI water and wastewater rate areas, and thus an equivalent percentage of the Acquisition Revenue Requirement would be allocated to CUCI. [IAWC Ex. 2.0R, p. 17.] As Mr. Gloriod indicated, IAWC anticipates that proposed rates reflecting those Savings will be filed prior to year-end 2002 (and possibly during 2001). [Tr. 516-17.]

i. Savings Are Sufficient To Provide Adequate Benefits to Customers

Mr. Gorman and Ms. Everson raised a concern that Savings allocations to customers under the SSP are insufficient to provide adequate benefits to customers. [IIWC Ex. 1.0, p. 8; ICC Staff Ex. 2.0, pp. 5-7.] Mr. Flaherty addressed this issue, explaining that the Savings will exceed the total of (i) the 10% allocable to customers and (ii) the amount required to cover the Acquisition Premium Revenue Requirement after year 13. Until year 13, the customers will receive 10% of the annual savings even before IAWC obtains recovery of any part of the Acquisition Revenue Requirement. More importantly, however, both of these witnesses fail to acknowledge that these Savings will continue, absent exogenous factors, into perpetuity. Thus, both witnesses are actually understating the anticipated Acquisition Savings level, because year 40 savings will continue to increase each year since all prior savings "events" have occurred and are permanent. [IAWC Ex. 9.0R, pp. 14-15.] It is important to recognize that this ongoing Savings stream will benefit customers for the foreseeable future. In addition, once the Acquisition Premium is recovered, the Savings that accrue to the customers become even higher. This is particularly relevant where any long-term comparison is made or when a present value analysis is made, such as that contained in Schedule 4 of Mr. Gorman's exhibit. In this Schedule, he has ignored the ongoing value of annual Savings after year 40 and has, therefore, substantially understated the benefits to customers on an absolute basis and relative to the Acquisition Premium. [*Id.*, p. 15.]

Mr. Flaherty further explained how these ongoing Savings levels should be reflected. Were complete lifecycle calculations to be made, these Savings would be reflected through the use of a "terminal value". A "terminal value" reflects the value of a distant stream of continuing cash flows beyond a predefined analysis period. The use of a terminal value is a relatively simple, frequently used financial concept, and is calculated in accordance with the following equation, where the last year's savings amount reflects year 40 of the amortization period:

The Last Year's Amount / (Discount Rate - Inflation Rate)

In this case: The Last Year's Amount of Savings = $20,895,747

Discount Rate = 8.76%

Inflation Rate = 2.5%

Or: $20,895,747 / (8.76% - 2.5%) = $333,797,747

Using IAWC's cost and Savings figures and the discount rate of 8.76% used by Mr. Gorman would produce: a Discounted Terminal Value of $10,672,014. In other words, adding the value of benefits over the 40-year amortization period to the terminal present value, yields a total discounted value of approximately $90 million as shown below:

	Total Present Value ($ in thousands)
Base Period:	$80,004
Terminal Value	$10,672
Total:	$90,676

[IAWC Ex. 9.0R, pp. 16-17.]

Mr. Borden suggests that the Commission should be concerned that projected Savings are lower than the actual allocated Acquisition Adjustment for the first twelve years after the

Acquisition. [ICC Staff Ex. 5.0, p. 7.] Mr. Borden fails to note, however, that in all rate cases filed during period when the SSP is in effect (including the first twelve years) ratepayers will receive 10% of the Demonstrated Savings (irrespective of the amount of the Acquisition Revenue Requirement). [IAWC Ex. 2.0, p. 8; 3.6R.] As Mr. Hamilton explained, in IAWC Exhibit 3.1R, however, Savings are projected over the next 40 years, and discounted back to their present value in the earlier years under the Company's plan. This concept is well founded in financial theory, and simply says, "a dollar today is worth more than a dollar received 40 years from now." By discounting the stream of Savings dollars over 40 years back to their 2000 equivalents, the time value of money is given full consideration. The Acquisition Adjustment, on the other hand, represents dollars spent by the Company today, that have to be amortized over the next 40 years. It is the reverse situation from the present value of the future Savings just described. At the outset, the Company spends capital today for the Acquisition, and must wait for its return, or "pay back" in the future. In the other instance, there is an accumulation of Savings that will take 40 years to attain, but which must be quantified at their present value today. The Company projects that Savings will outweigh the amortized Acquisition Adjustment within the first 12 years. Twelve years is just over one fourth of the 40 years over which the total Savings have been estimated. As Mr. Mülle explained, that is not an unreasonable period, considering the long-term nature of the assets involved, their underlying financing lives and the long-term nature of the SSP. [IAWC Ex. 8.0R, p. 14.]

Mr. Gorman also contends that the Acquisition Costs are relatively high compared to the Acquisition Savings and that, as a matter of public policy, the Commission should not support such an acquisition. [IIWC Ex. 1.0, p. 2.] This theory also appears to be at the heart of IIWC's position. As Mr. Gloriod explained, Mr. Gorman cites no reference for judging the relative amount of Acquisition Costs and Savings. Mr. Gorman fails to note that under the SSP, nearly $140 million in net Savings will be returned to the ratepayers (Exhibit 3.6R) [IAWC Ex. 1.00, p. 11.] (As noted above, the present value of those net Savings as adjusted to include the terminal present value exceeds $90 million. IAWC Ex. 9.0R, pp. 16-17.) Such Savings are made possible only through the Acquisition. The shareholders are willing to spread their recovery of the Acquisition price over a forty-year period and to take the risk of limiting such recovery to Demonstrated Savings. The length of time over which the SSP will extend should not be a basis for disapproval of the SSP, which clearly will benefit the ratepayers. [IAWC Ex. 1.0R, p. 11.]

j. The Purchase Price Is Fair And Reasonable

Ms. Langfeldt suggests that the acquisition multiples that Mr. Bobba presents are not sufficient for determining whether the purchase price is reasonable because each M&A transaction is a function of unique factors that contribute to the acquiror's perception of the value. [ICC Staff Ex. 3.0, pp. 4, 14.] As Mr. Bobba indicated, however, the five financial statistics which he chose to evaluate the reasonableness of the purchase price were selected because they are publicly available and are routinely considered by investment bankers for that purpose. [Tr. 343.] Mr. Hartnett also addressed this issue, explaining that acquisition multiples are the standard method used by investment bankers for verifying the reasonableness of the purchase price in all industries, not just water utility acquisitions. [IAWC Ex. 4.0R, p. 7.] The considerations mentioned by Ms. Langfeldt are the unique factors that an acquirer will consider in determining its offer price for the properties. There is a key distinction between determination of the specific value a willing buyer is prepared to pay to a willing seller versus the determination of how that purchase price compares to other transactions in the market for similar companies at that time. AWW determined the price it was willing to pay for Citizens' assets (based on the DCF analysis discussed by Mr. Hartnett). Mr. Bobba compares AWW's price and the resulting multiples for reasonableness compared to similar transactions in the market for water utilities at the time of the offer. Mr. Bobba's analysis is appropriate to evaluate the reasonableness of the negotiated price. [IAWC Ex. 4.0R, p. 6; TR 343.] The use of these multiples is readily apparent in Proxy Statements routinely filed with the SEC for acquisitions of public companies. In addition, research analysts in the securities industry also use this information to determine the reasonableness of a purchase price. [IAWC Ex. 4.0R, p. 7.] Ms. Langfeldt is criticizing a standard practice used by Merrill Lynch, and every investment banking firm on Wall Street, to determine the reasonableness of a purchase price relative to comparable transactions. [*Id.*, p. 7.]

Ms. Langfeldt also suggested that IAWC should conduct a reliable and accurate DCF analysis of CUCI both including and excluding merger savings. [ICC Staff Ex. 3.0, p. 17.] Mr. Hartnett agreed that a DCF analysis is a reliable valuation technique which assumes that the value of the assets is equivalent to the value of their cash flows, which would include the Acquisition Savings. [IAWC Ex. 4.0R, p. 8.] Mr. Hartnett prepared a DCF analysis for the Acquisition. This analysis established a value of $221,000,000 for the Utility Assets. [IAWC Ex. 4.1R.] The Illinois DCF result compares favorably to the allocated price for the Utility Assets of $219,900,000 in the Asset Purchase Agreement. Thus, the CUCI specific DCF study, therefore, fully supports use of the allocated purchase price in calculating the Acquisition Revenue Requirement. [IAWC Ex. 4.0R, p. 8.]

k. The Commission Cannot Consider a Non-Existent Alternative

Staff witness Borden suggests that the Commission disapprove the Acquisition proposed in this proceeding because of speculation that a better proposal might someday be filed. [ICC Staff Ex. 11.0, pp. 4, 9, 22.] This approach, however, is contrary to law. Section 7-204 does not require a showing of a positive public benefit, but requires only a showing of no adverse impact on ratepayers. Consequently, if the Acquisition and SSP, together, are shown to have no adverse impact on ratepayers under the standards of Section 7-204(b), the Acquisition must be approved. In this case such a showing has been made (Discussion at pp. 38-42 *infra.*). It is improper, therefore, under this statutory framework, to consider alternative transactions, since one cannot be "better" than another under the applicable statutory criteria, assuming that each alternative does not adversely impact ratepayers. To reject the current proposal in the hope that one with a lower Premium could someday come along would exceed the Commission's statutory authority by applying a standard not provided for in Section 7-204(b).

Second, there is no alternative transaction here. No alternate purchaser has appeared to proclaim its willingness to acquire the Utility Assets. Whether such an alternative purchaser would ever arise is pure speculation. Staff knows of no other viable alternatives and has no information that there may be one out there. [Tr. 853.] The Acquisition, together with the SSP, has been shown to meet the standards of Section 7-204(b) and, therefore, must be approved.

I. Recovery Of The Acquisition Adjustment Will Not Result In Uncontrolled Pricing And Will Not Affect How Much An Investor Is Willing To Pay

Mr. Smith contends that, if the Acquisition Adjustment is allowed to be recovered from customers, there would be no limit to what an investor would be willing to pay for a utility operating system. [ICC Staff Ex. 1.0, p. 10.] Mr. Borden and Ms. Langfeldt also contend that including the Acquisition Premium in rates will lead to ever increasing prices paid for utility assets. [ICC Staff Ex. 5.0 pp. 3, 6; ICC Staff Ex. 3.0, pp. 8-9.] However, the purchase price for the Utility Assets and, therefore, the level of the Acquisition Adjustment, is fully supported by the level of the discounted value of the expected cash flow from the acquired Utility Assets, including the Acquisition Savings. This connection between discounted value of incremental cash flow resulting from the Acquisition and the Premium eliminates Mr. Smith's concern with regard to uncontrolled pricing. [IAWC Ex. 2.0R, p. 6.]

As Mr. Hamilton also explained, the "circularity" argument raised by Mr. Borden and Ms. Langfeldt is incorrect. As long as the principle that recovery of a merger or asset acquisition premium should result in no net cost increase to customers is the standard, there is a limit to what an acquirer would be willing to pay for utility assets. That limit would be that the sum of cash flow from existing operations and expected savings from an asset acquisition are a ceiling on the purchase price (and, therefore, the premium). The requirement that the transaction not result in any net cost to the customer provides checks and balances to the amount of a merger or asset acquisition premium that a company can pay and expect to collect through rates. To the extent that a company pays a price in excess the current value of DCF (including cash flow from savings), it should fully expect to absorb that excess premium without rate recovery. [IAWC Ex. 7.0R, pp. 11-12.]

Mr. Borden also asserts that, if AWW can recover the acquisition premium in rates, it has an interest in inflating that acquisition premium. [ICC Staff Ex. 5.0, p. 15.] Mr. Hamilton explained that, under the SSP, the total Savings that are expected to result from the acquisition of the Utility Assets act as a limiting factor to the purchase price because a company would expect to have to absorb the amount of any premium related to payment of a purchase price which exceeds the current value of DCF. The purchase price in this transaction was negotiated on an arms-length basis between two independent parties and is, thus, the best indication of the fair market value of the Utility Assets. The maximum price that Illinois-American would have any incentive to offer for the CUCI water and wastewater Utility Assets would be equal to, or less than, the discounted value of cash flows (including Acquisition Savings) that it believed could be obtained if it owned those assets. Any premium in excess of the incremental amount of the discounted cash flows expected to be realized would be absorbed by shareholders. [IAWC Ex. 7.0R, pp. 12, 15.]

For this reason, the primary focus should be on the Savings that can be produced by the Acquisition, not the price of the Acquisition. A proposal, such as the SSP, that limits the recovery of the investment to an amount consistent with realized Savings, eliminates Mr. Borden's perceived risk that allowing Acquisition Premium recovery could lead to ever higher asset purchase prices. [IAWC Ex. 1.0R, pp. 9-10.]

m. The Company's Proposed Allocation Of The Purchase Price Will Allocate Only An Equitable Share To The Utility Assets

Ms. Langfeldt suggests that the purchase price for the Utility Assets was established from a highly questionable allocation of the total purchase price to the various companies included in the Acquisition. Ms. Langfeldt further suggests that AWW's allocation of the purchase price among the various state jurisdictions involved fails to recognize the future cash flows of each CUC subsidiary to be acquired by AWW, including CUCI, and fails to demonstrate that the proposed Reorganization will not unjustly subsidize non-utility activities and regulated activities in other jurisdictions. [ICC Staff Ex. 3.0, p. 6.] As Mr. Hartnett explained in his Rebuttal Testimony, in October, 1999, AWW had sufficient information to prepare a combined DCF for all of Citizens' water operations to determine an offer price, but had to allocate the price to each state on the fairest basis possible. Given the nature of an asset purchase transaction, the original cost of the assets (gross PP&E) was the most logical basis upon which to allocate fair market value. [IAWC Ex. 4.0R, p. 3.] The allocated purchase price for the Utility Assets is fully supported by an Illinois-specific DCF analysis. Therefore, the allocated price is fair and reasonable and does not unjustly subsidize non-utility activities. Moreover, had AWW utilized the net PPE factor to allocate purchase price, as suggested by Ms. Langfeldt, the amount of the purchase price allocated to Utility Assets in Illinois would have increased. [Tr. 458-59.] For these reasons, use of the purchase price in calculating the amount of the Acquisition Premium does not (as Ms. Langfeldt suggests) cause a violation of Section 7-204(b)(2) of the Illinois Public Utilities Act. [IAWC Ex. 4.0R, p. 3.]

Mr. Borden suggests that, if the Commission decides to approve the Company's proposal regarding the Acquisition Adjustment, it is important that CLW be allocated an equitable share. As Mr. Ruckman explained, the Company agrees with Mr. Borden's suggestion, and points out that, as demonstrated in its response to DAB 1.10, the Company's proposed allocation of purchase price will in fact allocate an equitable share to CLW. The Acquisition Adjustment is based on the purchase price for the Utility Assets. As discussed by Mr. Hartnett, this price is consistent with the discounted value of available cash flows (including the Acquisition Savings). An appropriate share of the overall purchase price has been allocated to CLW, but that does not affect the Acquisition Adjustment. [IAWC Ex. 2.0R, p. 15.]

n. Use Of The Home Mortgage Method Chosen By IAWC Is Proper

Ms. Everson discusses use of the Home Mortgage Method to amortize the Acquisition Adjustment. [ICC Staff Ex. 2.0, pp. 6-7.] Illinois-American has proposed using the Home Mortgage Method to amortize the Acquisition Adjustment because the use of that method produces level revenue requirement amounts over the life of the amortization period. It also produces a lower present value amortization amount than would be produced using the straight-line method. Customers benefit by using the method that produces the lowest net present value amount. [IAWC Ex. 7.0R, p. 9.] Ms. Everson conceded that many amortization approaches are appropriate and that she has no alternative method to recommend. [Tr. 711.]

As discussed above at page 4, if the ICC approves the Home Mortgage Method of amortizing the Acquisition Adjustment, Illinois-American would record a regulatory asset for the difference between the amortization that would be produced by using the straight-line method and the amortization produced by using the Home Mortgage Method. This regulatory asset would be recovered at the back end of the mortgage amortization period with no adverse effect on rates at that time. [IAWC Ex. 7.0R, p. 9.] To permit recording of the regulatory asset, the Order in this proceeding should expressly authorize recovery in rates of the Acquisition Adjustment under the Home Mortgage Method to the extent of 90% of the Demonstrated Savings, as defined in the SSP.

Ms. Everson sponsored ICC Staff Exhibit 2.0, Schedule 1.0 titled "Staff Calculation of Savings/Sharing Plan." As Mr. Ruckman explained, this Exhibit does not provide a complete illustration of the SSP, and is misleading. An accurate and complete illustration of the SSP was provided by the Company in response to IIWC Data Request No. 1, which is marked as IAWC Ex. 2.2R. IAWC Exhibit 2.2R includes a comparison of the Cost of Service (or Revenue Requirement) under the SSP to the Cost of Service without the Acquisition. The illustration shows that ratepayers benefit from Savings in all years. Staff's Exhibit omits this critical comparison and in fact implies that an adverse rate impact results from the Savings Sharing Proposal, which cannot happen. [IAWC Ex. 2.0R, pp. 13-14.]

o. Staff's and IIWC's Modified Proposals: Control Premium

Mr. Gorman and Ms. Langfeldt, neither of whom has ever before participated in a proceeding involving a utility reorganization [Tr. 708 (Gorman); Tr. 784 (Langfeldt)], suggest an alternative method to calculate a "control premium." Mr. Gorman estimates that such a premium would be $21.3 million. Ms. Langfeldt does not estimate the amount of such a premium, but suggests a definition of "control premium" based solely on the testimony of a witness in a prior proceeding, a definition not adopted by the Commission. [Tr. 790-94; *Central Illinois Public Service Company and Union Electric Company,* Docket 95-0551, 1997 WL 709598, at *36-37, (Ill. C.C., Sept. 10, 1997.), 180 PUR 4th 185. Ms. Langfeldt also concedes that her definition is not found in USOA or in any legal or financial text she had consulted. [Tr. 787.] As Mr. Mülle explained, recognition of acquisition costs based on the "control premium" approach, suggested by Mr. Gorman and Ms. Langfeldt, does not provide an appropriate economic incentive for the shareholders to proceed with the transaction. As Mr. Mülle explained, Ms. Langfeldt suggests an alternative method to calculate a "control premium", but does not suggest a specific level. IAWC Exhibit 3.6R analyzes the "control premium" approach suggested by these witnesses, using Mr. Gorman's estimate. As discussed above, under Staff's primary proposal to disallow all Acquisition Costs, more than the amount of available net Savings is awarded to ratepayers at the expense of shareholders. For the "control premium" approach, the result is not much different. Using Mr. Gorman's estimate of the control premium, IAWC Exhibit 3.6R shows a negative one hundred seven percent (-107%) return to shareholders. On the other hand, ratepayers would receive one hundred ninety-one percent (+191%) of the available net savings. Clearly, there would be no financial incentive for the shareholders to proceed with the transaction. At a minimum, the ratemaking treatment of the Acquisition Adjustment must provide shareholders with an opportunity to recover the Acquisition Revenue Requirement. [IAWC Ex. 8.0R, p. 17.] The control premium approach, however, does not do so. [IAWC Ex. 1.0R, p. 8.]

Mr. Hamilton and Mr. Mülle disagreed with Mr. Gorman's contention that the control premium is the only portion of the acquisition price that should be subject to possible recovery. The adjustment Mr. Gorman would allow is the dollar value difference between the prevailing market value, and the acquisition price, referred to as the "control premium." However, as Mr.

Hamilton and Mr. Mülle testified, this definition does not apply to entities regulated on the basis of original cost, as was CUCI at the time of its last rate proceeding (Docket 94-0481). [IAWC Ex. 7.0SR, pp. 8-9 (Hamilton); IAWC Ex. 8.0SR, pp. 13-14 (Mülle).] The USOA is clear that the Acquisition Adjustment consists of the difference in value between net original cost, and the acquisition value, or price. [IAWC Ex. 8.0R, pp. 20-21.] As Exhibit 3.6R and the testimonies of Mr. Gloriod (IAWC Ex. 1.0R, p. 6) and Mr. Mülle (IAWC Ex. 8.0R, pp. 4-6) demonstrate, the Acquisition is financially feasible only if the Acquisition Premium is measured in the manner that the USOA requires.

p. Contributions In Aid Of Construction and Advances

Ms. Everson suggests that Illinois-American's proposed treatment of CIAC would require IAWC's customers, including the former CUCI customers, to pay Illinois-American a return on contributed assets. [ICC Staff Ex. 2.0, p. 9.] As Mr. Ruckman explained, CUCI's CIACs are not being recorded on the Company's balance sheet because CUCI is selling assets. Mr. Hamilton explained the reasoning for this treatment, and confirmed its appropriateness in his rebuttal testimony. How CUCI financed its water and wastewater utility assets prior to the acquisition of those assets is irrelevant in the context of an asset purchase transaction. Illinois-American is buying the Utility Assets for cash and, therefore, is financing those assets with debt and equity, which financing requires a return. In effect, Illinois-American has replaced the CIAC and advances with shareholder funds and will incur the cost to finance that debt and equity. [IAWC Ex. 7.0R, p. 10.] Nevertheless, IAWC will not propose to require its customers to pay a return on the assets previously contributed to CUCI. As Mr. Ruckman indicated, the Company will recognize CIACs for ratemaking purposes in its development of rate base. The level of CIAC's on Citizens' balance sheet at closing will be recorded as a rate base deduction, and diminished over time by the accumulation of amortization of CIACs (account 272). Accordingly, no adverse rate impact will result and the concerns that Ms. Everson raises are satisfied. [IAWC Ex. 2.0R, p. 13.] The Company will treat advances in the same manner as CIACs in the calculation of rate base. [*Id.*, p. 13.]

B. The Acquisition, Together With The Saving Sharing Proposal, Meets The Section 7-204(b) Criteria

Provided that the SSP or alternative ratemaking proposal is approved, the Acquisition meets the criteria set forth in Section 7-204(b). As Mr. Gloriod indicates, the Acquisition will position Illinois-American and AWW to bring to bear in Illinois (a) operating efficiencies associated with spreading consolidated management costs over a much wider customer base, (b) improved borrowing costs and buying power, and (c) enhanced and integrated critical resources in management, technology, engineering, water quality, customer services and source of supply planning. [IAWC Ex. 1.0, p. 6.]

Section 7-204(b)(1). Illinois-American is committed to providing adequate, efficient, safe and least-cost service, as is demonstrated by its consistent record of quality service. Illinois-American will bring this commitment to the area presently served by CUCI. The Acquisition, as proposed by IAWC, will not adversely affect Illinois-American's ability to provide adequate, reliable, efficient, safe and least-cost public utility services. [IAWC Ex. 1.0, p. 7.]

Sections 7-204(b)(2) and 7-204(b)(3). As shown above at p. 44-45, the Acquisition will not result in any unjustified subsidization of non-utility activities by Illinois-American or its customers. At present, neither Illinois-American nor CUCI engages in a significant level of such activity. To the extent that Illinois-American engages in such activities in the future, it will continue to maintain its books and records in such a manner as to fairly and reasonably allocate utility and non-utility activities, and allow the Commission to identify those costs and facilities that are properly included for rate-making purposes. [IAWC Ex. 1.0, p. 7.]

Section 7-204(b)(4). As discussed above, the size of the combined company will result in improved access to capital at lower rates, provided that the SSP or alternative ratemaking proposal is implemented. [IAWC Ex. 1.0, p. 6.] For the reasons discussed above (pp. 13-16), if IAWC is not provided with an opportunity to recover the Acquisition Revenue Requirement in rates, the Acquisition would significantly impair the Company's financial position and prevent the attraction of capital on reasonable terms or maintenance of a balanced capital structure. Thus, if the SSP or alternative ratemaking proposal is not approved, the Acquisition would not meet the requirements of Section 7-204(b)(4).

Section 7-204(b)(5). Illinois-American will remain subject to all applicable laws, regulations, rules, decisions and policies governing the regulation of Illinois Public Utilities. [IAWC Ex. 1.0, p. 7.]

Section 7-204(b)(6). Due to the geographical separation of their service areas, there is no significant competition for customers and/or water sales between CUCI and Illinois-American. Accordingly, market conditions in Illinois after consummation of the Acquisition will be substantially the same as those currently existing. The Acquisition, therefore, is not likely to have a significant adverse effect on competition in Illinois. [IAWC Ex. 1.0, p. 8.]

Section 7-204(b)(7). As discussed above (pp. 38-42), under the SSP or alternate ratemaking proposal, the Acquisition will have no adverse rate impact.

All of the criteria of Section 7-204(b) are met by the Acquisition, together with the SSP, and the Commission should, therefore approve the Acquisition and authorize implementation of the SSP.